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MUNICIPAL BONDS

Facts Regarding Their Issue and Their Security

By Frederick Lownhaupt



MUNICIPAL BONDS

FACTS REGARDING THEIR ISSUE AND
THEIR SECURITY

BY
FREDERICK LOWNHAUPT
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BOOKLET NO. 4 OF A SERIES ON BONDS
See Page 32 for Other Titles

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...CONTENTS...

Nature of Bond	- - - -	6 ✓
Banker's Investigation	- -	7
Territorial Source of Issue	-	8
Commercial Considerations	- -	10
Population and Character of Town		12
Utilities	- - - -	14
Integrity of Municipality	- -	14
Matters Affecting Debt	- -	15
Debt Limit	- - - -	16
Purpose of Issue	- -	20
Authorization	- : -	21
Legality	- - - -	22
Marketing	- - - -	25
Investment Position	- -	28

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MUNICIPAL BONDS

IN consideration of this large and prominent class of investments, constituting as it does fully twenty per cent. of all bonds issued annually, and in total representing a sum approximately three times as great as the entire bonded debt of the United States, or, expressed in figures, something like \$2,700,000,000, it is well to begin with a look at the nature of the corporations issuing these securities. In the generally accepted sense of the term when reference is made to corporation bonds, it is intended to convey the idea of corporations of the character of a railroad or public utility concern, though it is, of course, true that municipalities are corporations. A more concise definition of a municipality would be that it is a political sub-division known as a city, county, school district, town or village. There are yet other specially organized municipalities, so-called, which are designated as drainage dis-

tricts, levee districts, irrigation districts, etc., found more especially in the South, Southwest and West. Although we apply to a county the term of municipality, strictly speaking it cannot be so considered nor can any of these special districts mentioned. Levee and drainage districts are not true municipalities. They are generally specially organized pieces of territory embracing several municipalities which may need the drainage in parts or require the building of levees to hold back a river. The bonds issued by these districts are payable from taxes levied upon all of the property within their particular boundaries.

Nature of Bond.

What, then, are municipal bonds? They are like Government bonds insofar as they are a promise to pay based on the faith and credit of the political sub-division issuing them. They are evidences of debt running a number of years. When a railroad or similar corporation wishes to borrow money it may issue stock or borrow temporarily from a bank, but more often issues its bonds, its promises to pay. A municipality does likewise when it issues

bonds. There are, however, various other instruments put out by municipalities chiefly among which are warrants. In some parts of the West, cities issue these warrants, which may be for salaries owing, payment of contracts, etc., and are payable when the municipality is in funds. Any such instrument is essentially local in its character while the true municipal bond differs materially from it in many respects.

Bankers' Investigation.

In treating of municipal obligations as investments and the elements of their security and value it is well for the investor to keep one prominent fact always in view. This is the fact that the security has had a searching investigation by the banking house offering it for sale; and that because of the scrutiny and analysis to which the bonds have been subjected their worth is established. Furthermore, the banker has bought them for himself. It is well for investors to know the fundamental requirements of a good investment, but it is reassuring to know that the banker has thoroughly satisfied himself in every respect.

Let us see, therefore, what the banker considers in ascertaining the value and safety of an issue of municipal bonds offered to his house. As we have said before, he examines and purchases an issue with a view to both buying and selling well. In making his bid that is submitted to the municipality offering the securities, every point that will be enumerated must be considered separately, so that the bid may be successful from the two points of view mentioned. Should he not give due attention to every item some flaw might be discovered after the bonds had passed into the possession of his clients and the general investing public.

Territorial Source of Issue.

Perhaps the very first point which is given thought and one that may be settled almost immediately by experience is that of the territorial source of the issue. The banker knows well that the investing public of this country show considerable partiality with regard to location when contemplating the purchase of municipal securities, showing a considerable preference for older communities which have

been settled for some time. Securities coming from freshly settled sections do not appeal to conservative investors even though they may be of excellent value. A town that is the direct result of a boom would not be well considered. It is a fact well known by all dealers in municipal bonds that securities issued by Southern towns are very much less favorably received than obligations springing from Northern territory. The geographical aspect of the matter, however, broadens somewhat in the case of the Southern States and involves economic factors not present elsewhere. Many investors take into consideration the fact that almost half of the population of those States is of the colored race. In the case of many Southern cities, while the population may be sufficient in numbers, there may be too large a proportion of negroes, who are not ordinarily as thrifty and do not have the same amount of wealth per capita as the white people. Some bond dealers, however, do not put as much stress on this point, as from their knowledge of conditions they do not justify the attitude of investors in a prejudice against Southern mu-

nicipal investments. It is the testimony of these bond men that many municipal bonds from that section are now of a high order of safety. Aside from this sociological-economic factor, a matter of history influences investors. Many of the Southern States repudiated large debts just after war times, a fact which lives in the minds of many.

Commercial Considerations.

If an issue of bonds is acceptable on the vital point of territory, a next consideration is the commercial conditions existing. A one industry town is avoided. As has occurred in numerous instances, the town may be largely centered about the life and stability of that single factory, as it may be. The natural result of the vicissitudes of the industry would be reflected in the general conditions of the town. Should the industry be compelled to seek another location there would be small reason for further existence of the town. The railroad and water facilities of the town or city are pertinent aspects of the matter. They are of special importance to the bond dealer when considering the purchase of bonds. If these utilities are

ample the stability and market value of the securities will be strengthened. An old city in a populous community in which are located many manufacturing enterprises of long and high standing, where growth has been slow but steady, and which has always met its obligations at maturity, would manifestly meet with easier success in floating its obligations than would a comparatively young city in practically a new community where the growth has been rapid. Of course there are cities in the West and Northwest, which are exactly described in the last part of the previous paragraph, yet with all their newness they are making tremendous strides in wealth and population and are the center of great industries. Because of their advantageous location and prospective growth their bonds sell on a basis approaching those of older and wealthier cities. Care should be exercised, therefore, to see that the business conditions of a community are stable before investing in its bonds. It would be poor judgment to purchase long-time bonds of a city which is exclusively dependent upon such an industry as mining for

the reason that should the mines give out the community would not be able to meet its obligations. Agricultural and manufacturing communities with ample transportation facilities are more stable.

Population and Character of Town.

As a corollary to the matter of commercial importance of a city or town, various aspects of population are to be noted. Its growth for a few years past is studied. It is advisable to carefully ascertain from past reports the growth in population for a period of say ten years. It is, of course, well that it be active and growing. Of course an investigation of this phase of the question involves the character of the population and the town in general. Character is a vital factor in the matter of municipal credit. There is such a thing as a moral character of a city quite as much as that of an individual. It is reflected more or less in the basis on which a city's credit stands. As an element in the consideration of municipal bonds it is important. The record of government for some years previous is an index. The political complexion of the place requires at-

tention. Incapable or corrupt officials can seriously injure the municipality. Then there is the condition of the homes and public buildings, public improvements, the condition of the streets, sewerage, the commercial pursuits and the need of the utility to be acquired by the bonds, the city's method of doing business, the advantages the municipality offers its people or prospective residents, and a great many other things which go to make up the character of the city.

The question of population is comparatively simple in nature, attention being given to the number of inhabitants, this being determined by the Federal census or a certified statement by the officials of the municipality. In a word, if it can be shown that the place has been of a steady growth, that the record of its progress since its incorporation has been consistently forward, that new industries are locating and that old ones are doing well, that there are ample transportation facilities and the necessary public utilities, it may be taken as evidence that the citizens are of a progressive nature and bending every energy to advance

the welfare of the community. The banker requires a full record, historical and otherwise.

Utilities.

For the past few years the growing agitation over the question of public ownership of the utilities has brought this aspect of municipal affairs into the reckonings of the bond dealer. If these are owned by a town and creditably administered, the assets of the place are by so much enhanced. Operated for the distribution of political favors and under the domination of politics, as largely found at present, they cannot serve as a developing influence in the community. Up to the present, experience has demonstrated that private ownership of public utilities is best.

Integrity of Municipality.

Finally, so far as determining the moral and physical condition of the municipality is concerned, the banker will have regard to the promptness in liquidation of its obligations. The history of some sections of the country shows the evidence of a spirit of delay and the pursuit of dilatory tactics in meeting obligations. A few sections of the West were guilty

in years past. The New England States have always stood conspicuously for the opposite policy. With them it has been an anxiety to pay off the debt. Municipalities like New Haven, Conn., have ever manifested the greatest alacrity in ridding themselves of the obligations. All over the country, however, in recent years, there has been a growing tendency to shorten the term of the debt in period of years, or by paying off on the installment plan, that is, periodically until the whole amount is retired.

Matters Affecting Debt.

After some conclusion is arrived at relative to all of the above points, other very essential matters must be considered and satisfactorily regarded. Under one broad head these may be called the financial conditions. They include such things as the relation of the total debt of the municipality to the assessed valuation of the property within its borders, the relation of the debt to the total population, the tax rate and the tax limit, the personal tax rate and the increase in real and personal property for a

series of years past, say ten years. Let us see what is the relation of these items to a new issue of bonds offered.

Debt Limit.

The total amount of the existing indebtedness and of what it consists. The total amount is, of course, the gross debt, and is obvious. The net debt of municipalities, however, is not identical all over the country. This is by reason of variations of laws in the different States. Part of the indebtedness is often created for special assessment purposes, or the building of water-works, electric light plants, etc., and by authority of law the bonds issued for the production of these utilities may be excluded or deducted from the gross debt to arrive at the total of net debt. Cities and towns are corporations and depend for their rights on their charters. These charters are granted by the State and contain certain limitations regarding their powers.

One of the ordinary limitations is the amount of debt which a city may assume or have outstanding at any one time. In the State of New York the constitution limits the amount of net

indebtedness to ten per cent of the assessed valuation. Other States vary in the figure set. They vary from two to thirty per cent., although in the majority of States from five to ten per cent. There is not so much variation in the percentage of the assessed valuation that the net debt may represent as in the percentage of the actual appraised value that the assessed valuation represents.

A wide divergence exists among the different States in respect to the proportion of the actual or appraised value that the assessed valuation represents. While the proportion of net debt to assessed valuation varies from five to ten per cent. the percentage of assessed valuation to actual valuation varies from forty per cent. to eighty per cent., depending upon the section of the country. In New England it is high; in many of the Western States low. The net debt of many municipalities is arrived at by deducting from gross figures the amounts of sinking funds held, in addition to bonds representing utilities that are self-sustaining, such as the water debt. In regarding the financial condi-

tion of a municipality the ratio of debt to assessed valuation is a first consideration. A financial statement of a city includes such items as all taxable property, real and personal, any assets which the city may have, such as water-works, or electric light plants, any accumulated sinking funds. The assessed valuation represents the property value, real and personal, as fixed by the assessors for the purpose of taxation. It is difficult to lay down a hard and fast rule as to what the limit of debt should be. There is an open question as to what is an excessive debt. This is a matter which cannot be definitely stated as the varying conditions of different municipalities make it impossible to pass final judgment on any one from conditions existing in another. In some places ten per cent. would seem to be excessive while in others even so high a figure as twenty-five per cent. might be regarded as reasonably safe. Many bankers, however, look upon ten per cent. as about the proper limit, beyond which safety and security decrease.

It may be assumed that whatever limit is set by the constitution of the respective State is

safe. The figure of two per cent. is what Louisiana makes, while in Kansas it is as high as thirty per cent. New York allows ten per cent. of the real estate assessment; Pennsylvania, seven per cent. of the real and personal; Ohio, eight per cent. of real and personal; California, fifteen per cent, etc. In one or two States there is no limit, each issue requiring legislative enactment. The facts that the assessed valuation is but a percentage of the supposed actual or selling value; the debt is but a comparatively small percentage of the assessed valuation, and the interest on that debt from three to five per cent. on an average, make it evident that owing to the debt limit provisions, the interest charges cannot ordinarily become large enough to be burdensome to the taxpayer. Nevertheless, the tax rate is an important item in the general scheme of a city's financial showing that is considered by bankers. No city, however prominent and wealthy, is inexhaustible in its tax resources. It is a fact that the credit of a city declines as its tax rate rises, and a deterioration of the city's credit due to increased taxation might compel it to raise its interest rate.

Purpose of Issue.

Again, the banker having satisfied himself in regard to the general questions, moral and physical and financial in nature, in regard to the municipality, he turns his attention to the bond issue itself. First of all, for what purpose are the proceeds to be used? This is very important. In issuing a municipal bond it must be for strictly municipal purposes. So long as bonds are issued for water-works plants, erection of schoolhouses, for the construction of sewers, etc., for city, county and other public buildings, and for various improvements of that character it is well. They are then within the law. Bonds for some of the purposes just mentioned are perhaps more popular than others, yet they all find a good market.

Bonds issued as bonuses to manufacturing industries are not favored because the industries may not bring the benefits anticipated and because of an element of danger that the people may seek to avoid payment of the obligations at maturity. Instances of this kind have happened, as have cases where bonds were issued and given to railroad promoters to

run a line through a town. The railroad never appearing, the people have been loath to redeem their obligation. These bonds to encourage railroads were most numerous of all illegitimate bonds in years past, but have all disappeared. A more recent example of bonds for a purpose not strictly municipal is the type issued for the encouragement of the beet sugar industry in the West. Even other grossly improper schemes have been fostered by municipal issues through some subterfuge. The banker, therefore, finds it essential that the purpose of the issue be well established before purchase.

Authorization.

The authority for the issue resides in the law—in the constitution of the State. In the case of many of our larger cities it is upon their charter; in the case of counties, school districts, etc., upon resolutions of their respective governing boards. Small municipalities must authorize the issue by an election. But in the case of the larger cities of New York State the measure must be passed upon by the Common Council and approved by the Board of Estimate and Apportionment.

Legality.

An investigation of the propriety of an issue with regard to the points just touched upon is but part of the general investigation of the total validity, that is, the legality of the issue. In the early days of municipal bonds it was not a practice to make a searching investigation of the obligations put out by a town or city, so that there should be no doubt cast upon them as to their conformity to the law. It was taken for granted largely that they were correct in every respect. That the municipality should offer them at all was ground for this assumption. Frightened more or less by the repudiations of a generation ago and because of the specialization that was developing in this type of security, banking houses a few years back began to employ expert counsel to pass upon their prospective purchases before paying for them. From this practice have developed a number of prominent and very expert specialists in the laws governing municipal bonds. When expert legal opinion was first sought in these matters, houses began inserting in their bids that the issue would be accepted and paid

for only after a certified transcript of proceedings satisfactorily evidencing to their attorneys the legality and purpose of the issue had been furnished. While it is more general for the banking house to procure legal opinion of its own volition, a few of the larger cities throughout the country anticipate this action by submitting to some prominent counsel a full transcript of all their proceedings to have the legality passed upon and approved before offering the bonds for sale. Then when bids are invited, the advertisement, naming the counsel, states that his opinion will be submitted to the purchaser. Yet this is frequently not entirely satisfying to some very conservative houses. They have their own attorney pass upon all questions before or when offering their bid. Conditions are so that none but the best lawyers of this class are acceptable to both banker and investor. The notable exception in this matter of attested legality, and the only exception, is the city of New York. It will neither furnish a transcript of proceedings nor accept a bid with any conditions. Accept the bonds as offered or make no bid is its ultimatum. Any

conditions inserted in a bid invalidates it immediately.

The cardinal qualification of the attorneys for banking houses is naturally a very broad study and knowledge of municipal law. No two States of the Union exactly agree in many points. It is therefore a matter of large experience in this field which makes their opinions so valuable. Considering a bond issue they must work along two lines. They must see that it is in entire conformity to the laws of the State, and that all the details of the issue have been properly carried out. This latter point involves more than is apparent on the surface. Opinions on the subject vary, but anywhere from twenty-five to fifty per cent. of the aggregate municipal bonds are defective in the procedure of their issue. That is to say, flaws are detected by the attorneys in their examination. These defects are, of course, remedied in proper time. Many of them arise through ignorance or inefficiency of the officials of a town or city. Legality is an extremely important point with investors, as many of the defaults that have occurred in payment of municipal bonds have

arisen through some original defect. Some defaults have arisen through a seemingly impossible error-oversight of the officials in collecting a tax to pay interest. Such a temporary default, however, may be easily cured.

The advertising of an issue, proper preparation of the securities, etc., are all formalities that must be attended to with exactness. Should a citizen of the municipality discover irregularities in the issue, he may obtain an injunction preventing the officials from carrying out the operation. If the case were serious, litigation might ensue to settle the disputed question.

Marketing.

Because of the legal restrictions such as that one which is almost universal—the necessity of selling at par or above—some ingenuity is often necessary that an issue may be floated when market conditions do not warrant so high a bid. Under such circumstances it is possible for the bankers to offer par, but by arrangement have abnormally heavy expenses which are paid by the municipality. This acts as a rebate and reduces the price to market

conditions. Bids vary in their terms. They offer to buy the bonds on a basis, or, if a definite interest rate is stated a firm price may be named. In New York State village bonds, by law, must be bid for at par, with a rate of interest named. The result is a variety of fractional rates of interest.

Every aspect of a bond issue is more or less closely related to the market for that issue. Generally speaking, municipal bonds have a market according to their kind. There is the broad general market, the market that is practically within the borders of a certain State and the market that is almost entirely composed of institutions, as the savings banks. It is easy to see what contributes to make such distinct markets. The laws of many States make bonds of municipalities within their borders tax-exempt, and so these are sought by individual investors. Indeed, the marketability of municipal bonds among these investors is due largely to their tax-exempt feature in certain States. Executors and administrators of estates buy this kind of securities largely. Also because of the laws of

States there is a specialized institutional market. All the Eastern States in their provisions for investments by savings banks, permit the holdings of municipal securities with various restrictions, such as the population of the city, the percentage of debt to the assessed valuation, and the fact that they must never have defaulted in the payment of their interest. Massachusetts, perhaps, leads in the rigidity of its requirements, while New York is almost as strict. It follows that bonds that can meet the requirements of these States will enjoy an excellent market. Bankers take much account of the fact that certain bonds have only a limited market. The question of market has a standing objection with some bonds, particularly those issued by cities of moderate size. As they are not listed or quoted anywhere, the holder may have difficulty in converting them into cash. Some possess great convertibility and are active, others possess almost none and are inactive, the determining features being the size and importance of the municipality and the amount of the debt outstanding.

A restricted or a wide market is an important

question with the banker in figuring the value of a security, for a security unhampered by conditions can be sold at a better price. Naturally the bonds of a metropolis are more easily marketed than those of a less known community. Furthermore, bonds of well-established cities with no defaults behind them, sell at better prices than those of an unseasoned community.

Investment Position.

Touching upon the security of municipal bonds generally, and their value as an investment, there is everything to commend them. That they are suitable investments for that type of fiduciary institution, the savings bank, is *prima facie* evidence of their worth and safety. They are a tax lien upon all the property situated within the boundaries of a municipality, a lien enforceable through a tax levy against the property which could be sold under a tax sale in case of non-payment. This is the inherent element of strength in these bonds. It is the imperative duty of the municipality to meet both principal and interest which become a prior claim. Then again there is no danger

of an over issue. The constitutional debt limit is of value here. It is of value to both the taxpayer and the bond holder. They both know this is the decisive check to officials in the creation of debt. Besides the general credit of a city some bonds may be a lien on some revenue producing public work such as a water-works. A bulwark of safety to the investor is the stand the courts have taken on the matter of repudiation. They will compel a tax levy for a valid bond. The position of the Supreme Court of the United States has been strongly in protection of the bond holders.

Municipal bonds generally have indeed become second only to Government bonds. The words of Judge Dillon, who is recognized as the foremost authority on the subject, are:

"The Supreme Court of the United States has upheld the right of the holder of municipal securities with a strong hand and has set a face of flint against repudiation. Even when made on legal grounds it may be found by said court to have been the result of manipulations which have been deceitful and fraudulent. Further, the value of such securities is

largely due to the court's adjudication in respect thereto, and the Supreme Court now warns officials of all municipalities against such manipulation, which is no fault of the public, that it will stand firmly by the decrees that it has so frequently established."

Still another evidence of the position of this type of bond is the fact of its acceptability by the United States Government as security for deposit of public money with the national banks. The law and the courts set themselves to the protection of the bondholder, nevertheless, the banker before offering the security to the public makes an investigation which amounts to a personal investigation. His representative is sent to the town to make a visual examination of conditions. By spending a few days in the town it is possible to confirm previous judgments of the place.

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